

This paragraph (d) applies to scholarships, fellowship grants, grants, prizes and awards. The provisions of this paragraph (d) do not apply to amounts paid as salary or other compensation for services.

(2) *Source of income.* The source of income from scholarships, fellowship grants, grants, prizes and awards is determined as follows:

(i) *United States source income.* Except as provided in paragraph (d)(2)(iii) of this section, scholarships, fellowship grants, grants, prizes and awards made by a U.S. citizen or resident, a domestic partnership, a domestic corporation, an estate or trust (other than a foreign estate or trust within the meaning of section 7701(a)(31)), the United States (or an instrumentality or agency thereof), a State (or any political subdivision thereof), or the District of Columbia shall be treated as income from sources within the United States.

(ii) *Foreign source income.* Scholarships, fellowship grants, grants, prizes and awards made by a foreign government (or an instrumentality, agency, or any political subdivision thereof), an international organization (as defined in section 7701(a)(18)), or a person other than a U.S. person (as defined in section 7701(a)(30)) shall be treated as income from sources without the United States.

(iii) *Certain activities conducted outside the United States.* Scholarships, fellowship grants, targeted grants, and achievement awards received by a person other than a U.S. person (as defined in section 7701(a)(30)) with respect to activities previously conducted (in the case of achievement awards) or to be conducted (in the case of scholarships, fellowships grants, and targeted grants) outside the United States shall be treated as income from sources without the United States.

(3) *Definitions.* The following definitions apply for purposes of this paragraph (d):

(i) *Scholarships* are defined in section 117 and the regulations thereunder.

(ii) *Fellowship grants* are defined in section 117 and the regulations thereunder.

(iii) *Prizes and awards* are defined in section 74 and the regulations thereunder.

(iv) *Grants* are amounts described in subparagraph (3) of section 4945(g) and the regulations thereunder, and are not amounts otherwise described in paragraphs (d)(3) (i), (ii), or (iii) of this section. For purposes of this paragraph (d), the reference to section 4945(g)(3) is applied without regard to the identity of the payor or recipient and without the application of the objective and nondiscriminatory basis test and the requirement of a procedure approved in advance.

(v) *Targeted grants* are grants—

(A) Issued by an organization described in section 501(c)(3), the United States (or an instrumentality or agency thereof), a State (or any political subdivision thereof), or the District of Columbia; and

(B) For an activity undertaken in the public interest and not primarily for the private financial benefit of a specific person or persons or organization.

(vi) *Achievement awards* are awards—

(A) Issued by an organization described in section 501(c)(3), the United States (or an instrumentality or agency thereof), a State (or political subdivision thereof), or the District of Columbia; and

(B) For a past activity undertaken in the public interest and not primarily for the private financial benefit of a specific person or persons or organization.

(4) *Effective dates.* The following are the effective dates concerning this paragraph (d):

(i) *Scholarships and fellowship grants.* This paragraph (d) is effective for scholarship and fellowship grant payments made after December 31, 1986. However, for scholarship and fellowship grant payments made after May 14, 1989, and before June 16, 1993, the residence of the payor rule of paragraph (d)(2) (i) and (ii) of this section may be applied without applying paragraph (d)(2)(iii) of this section.

(ii) *Grants, prizes and awards.* This paragraph (d) is effective for payments made for grants, prizes and awards, targeted grants, and achievement awards after September 25, 1995. However, the taxpayer may elect to apply

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the provisions of this paragraph (d) to payments made for grants, prizes and awards, targeted grants, and achievement awards after December 31, 1986, and before September 26, 1995.

(e) *Residual interest in a REMIC*—(1) *REMIC inducement fees.* An inducement fee (as defined in § 1.446-6(b)(2)) shall be treated as income from sources within the United States.

(2) *Excess inclusion income and net losses.* An excess inclusion (as defined in section 860E(c)) shall be treated as income from sources within the United States. To the extent of excess inclusion income previously taken into account with respect to a residual interest (reduced by net losses previously taken into account under this paragraph), a net loss (described in section 860C(b)(2)) with respect to the residual interest shall be allocated to the class of gross income and apportioned to the statutory grouping(s) or residual grouping of gross income to which the excess inclusion income was assigned.

(f) *Effective/applicability date.* Paragraph (e)(2) of this section applies for taxable years ending after August 1, 2006.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 8615, 60 FR 44275, Aug. 25, 1995; T.D. 8687, 61 FR 60545, Nov. 29, 1996; 61 FR 65323, Dec. 12, 1996; T.D. 9128, 69 FR 26041, May 11, 2004; T.D. 9272, 71 FR 43366, Aug. 1, 2006; T.D. 9415, 73 FR 40172, July 14, 2008]

§ 1.863-2 Allocation and apportionment of taxable income.

(a) *Determination of taxable income.* Section 863(b) provides an alternate method for determining taxable income from sources within the United States in the case of gross income derived from sources partly within and partly without the United States. Under this method, taxable income is determined by deducting from such gross income the expenses, losses, or other deductions properly apportioned or allocated thereto and a ratable part of any other expenses, losses, or deductions that cannot definitely be allocated to some item or class of gross income. The income to which this section applies (and that is treated as derived partly from sources within and partly from sources without the United

States) will consist of gains, profits, and income

(1) From certain transportation or other services rendered partly within and partly without the United States to the extent not within the scope of section 863(c) or other specific provisions of this title;

(2) From the sale of inventory property (within the meaning of section 865(i)) produced (in whole or in part) by the taxpayer in the United States and sold outside the United States or produced (in whole or in part) by the taxpayer outside the United States and sold in the United States; or

(3) Derived from the purchase of personal property within a possession of the United States and its sale within the United States, to the extent not excluded from the scope of these regulations under § 1.936-6(a)(5),

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(b) *Determination of source of taxable income.* Income treated as derived from sources partly within and partly without the United States under paragraph (a) of this section may be allocated to sources within and without the United States pursuant to § 1.863-1 or apportioned to such sources in accordance with the methods described in other regulations under section 863. To determine the source of certain types of income described in paragraph (a)(1) of this section, see § 1.863-4. To determine the source of gross income described in paragraph (a)(2) of this section, see § 1.863-1 for natural resources and see § 1.863-3 for other inventory. Taxpayers, at their election, may apply the principles of § 1.863-3 (b)(1) and (c) to determine the source of taxable income (rather than gross income) from sales of inventory property (other than natural resources). To determine the source of income partly from sources within a possession of the United States, including income described in paragraph (a)(3) of this section, see § 1.863-3(f).

(c) *Effective dates.* This section will apply to taxable years beginning after December 30, 1996. However, taxpayers may apply the rules of this section for taxable years beginning after July 11, 1995, and on or before December 30,